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AGENDA ITEM 8a

TO: MEMBERS OF THE INVESTMENT COMMITTEE

- I. SUBJECT:** Corporate Governance - Corporate Board Diversity
- II. PROGRAM:** Global Equity
- III. RECOMMENDATION:** Provide direction on the implementation of options to address corporate board diversity within CalPERS' portfolio companies and the general marketplace.
- IV. ANALYSIS:**

Executive Summary

On February 6, 2008, California State Controller John Chiang addressed a letter (Attachment 1) to Charles Valdes, Chairman of the CalPERS Investment Committee requesting consideration of enhancing the importance of corporate board diversity within CalPERS' corporate governance activities.

At its March 17, 2008 meeting, the Investment Committee considered Controller Chiang's letter and directed staff to come back with a range of options CalPERS could take to elevate the importance of corporate board diversity. In addition, on March 17, 2008, the Investment Policy Subcommittee directed staff to include the additional wording "as well as board diversity" within Principles section III.B.2.4, Director Nominations. The Policy Subcommittee also asked staff to review all corporate governance policies and the Global Principles of Accountable Corporate Governance (Principles) and come back with any additional recommendations regarding corporate board diversity.

CalPERS views corporate board diversity as having a positive impact on the operating and investment potential of a business while also fostering a boardroom culture that promotes sustainable collaboration, innovation, and

accountability. CalPERS believes that a corporate board of directors should establish and disclose the mix of director attributes, experiences, diverse perspectives, and skill sets that are most appropriate for the company. This view derives from the observation that the global economy is becoming much more diverse and that successfully competing within this evolving economy requires adaptation and recognition of changing wealth and influence demographics. Staff agrees with Controller Chiang's perspective that diversity in the boardroom can inherently lead to greater creativity, more vigorous deliberation, and more integrity of processes, all of which are desirable traits and are consistent with principles of good corporate governance.

Staff reviewed CalPERS' corporate governance policies and principles to determine if additional references to board diversity were appropriate. In this review, it was evident that the Principles constituted the substance and core of all the "value" statements within the corporate governance program. This positioning of the Principles makes them the ideal location and framework for statements on board diversity and thus links diversity concepts to all of CalPERS' corporate governance activities. Inserting board diversity terminology into other corporate governance policies is therefore viewed as unnecessary.

There appear to be three possible actions, incremental to the change already directed by the Investment Policy Subcommittee, consistent with State Controller Chiang's letter and feedback from the Investment Committee and Investment Policy Subcommittee. The options are categorized by those appropriate to CalPERS' portfolio positions and those relevant to the general marketplace.

Portfolio Position Activity

The primary tool of CalPERS staff to proactively impact corporate behavior is through translation of the Principles into the annual Focus List process.

- Inclusion of corporate board diversity as a topic of company engagement within the Focus List Program.

General Marketplace Activity

CalPERS' actions as related to the general marketplace are the development of position statements, publication of statements, proxy voting, participation within corporate governance organizations and engagement with state and national legislation.

- Engage RiskMetrics (ISS), Glass-Lewis, Proxy Governance and Egan Jones on their corporate board diversity policies with the objective of encouraging them to adopt CalPERS' Principles on this issue.

- Obtain business proposals from vendors in the corporate governance resource pool for the development of an issue paper that sets forth “best practices” for corporations to follow in seeking diversity on their boards.

Background

California State Controller John Chiang addressed a letter on February 6, 2008 to Charles Valdes, the Chairman of the CalPERS Investment Committee, on the topic of corporate board diversity. Controller Chiang’s letter requested CalPERS consideration of enhancing the importance of corporate board diversity within CalPERS’ corporate governance activities and outlined three specific possibilities. At the March 2008 meeting of the Investment Committee, staff presented a report that contained market data on corporate board diversity and a description of CalPERS’ corporate governance activities in this area. Staff was directed to come back to the Committee with a range of options for proposed actions CalPERS could take to elevate the importance of corporate board diversity in the marketplace.

Staff presented an agenda item at the March meeting of the Investment Policy Subcommittee that recommended approval and adoption of the Global Principles of Accountable Corporate Governance (Principles). An amendment was proposed and approved by the Subcommittee that added language on corporate board diversity to section III.B.2 – Board, Director and CEO Evaluation of the Principles. The specific language adopted by the Subcommittee was to add the wording “as well as board diversity” to section III.B.2.4, Director Nominations. In addition, the Subcommittee directed staff to review all corporate governance policies and Principles and come back with recommendations for additional amendments to these documents regarding corporate board diversity.

Options

Staff believes that effectively impacting corporate board diversity as referenced in California State Controller John Chiang’s letter requires some distinction on the categories of activity. This distinction is warranted by the differing breadth of company coverage attached to the various corporate governance activities. For example, individual company engagement normally happens in conjunction with the annual Focus List process. The universe of companies covered by this engagement is small and tied to significant long-term stock price underperformance along with issues attendant to the Principles. In contrast, CalPERS endeavors to impact the behavior of the entire marketplace by publicizing the organization’s position on various topics along with encouraging other entities to adopt CalPERS’ position. Options linked to these two categories are reflected below:

Portfolio Position Activity

The primary tool of CalPERS staff to proactively impact corporate behavior is through translation of the Principles into the annual Focus List process. This process screens CalPERS' domestic index portfolio to identify companies with significant long-term underperformance and Principles related issues. Linked to the Focus List activity are instances where CalPERS actually nominates candidates for corporate board membership. This activity is carried out in accordance with the CalPERS Statement of Investment Policy for Corporate Governance Director Nominations which limits the scope of this activity to companies that meet one of three criteria:

- Focus List membership
- Monitoring List membership
- "Engagement companies"

The Focus List and Monitoring List stem from the Principles and the language attached to the "engagement companies" specifies that these companies' boards are "failing to perform in accordance with the Principles of Accountable Corporate Governance or in circumstances where a company has consistently demonstrated long-term economic underperformance." These direct and indirect references to the Principles make board diversity a consideration in the director nomination process. The action taken by the Policy Subcommittee to insert additional wording related to diversity into the Principles serves to reiterate consideration of this facet.

Deriving from the Policy Subcommittee action, the relevant activity for staff is:

- Inclusion of corporate board diversity as a topic of company engagement within the Focus List Program.

General Marketplace Activity

CalPERS' actions as related to the general marketplace are the development of position statements, publication of statements, proxy voting, participation within corporate governance organizations and engagement with state and national legislation. By their nature, these activities have the potential to impact a much wider group of companies in contrast to the portfolio position based activities. Options to further the general marketplace's awareness of corporate board diversity are:

- Engage RiskMetrics (ISS), Glass-Lewis, Proxy Governance and Egan Jones on their corporate board diversity policies with the objective of encouraging them to adopt CalPERS' Principles on this issue. Success in this engagement would make board diversity a consideration impacting

the proxy voting of a broad array of constituents and cover a wide group of companies.

- Obtain business proposals from vendors in the corporate governance resource pool for the development of an issue paper that sets forth “best practices” for corporations to follow in seeking diversity on their boards.

Staff Recommendation

In the category of portfolio position activity, staff believes the inclusion of board diversity as a topic attendant to company engagement through the Focus List Program will enhance this important issue.

For the category of general marketplace activity, on a regular basis staff communicates with the proxy advisory firms to discuss CalPERS’ corporate governance policies and Principles. In addition, on an annual basis staff compares CalPERS’ policies and Principles with those for the proxy advisory firms to identify policy position statements that are similar and dissimilar. Staff believes that engaging the various proxy and corporate governance service providers in an effort to encourage their adoption of CalPERS’ Principles position on board diversity, offers the most significant opportunity to advance California State Controller Chiang’s initiative.

V. STRATEGIC PLAN:

This agenda item is consistent with the Strategic Plan: Goal IX, achieve long-term, sustainable, risk adjusted returns.

VI. RESULTS/COSTS:

Incremental costs attached to the approval of this item are dependent on the feedback from the Investment Committee regarding the desirability of proceeding with the development of a “best practices” paper by an outside vendor. Taking the actions recommend by staff are viewed as “cost free” in that diversity would become an additional topic within the normal engagement process attached to the annual focus list. These efforts are viewed as advancing the organizations’ diversity objectives and raising the awareness level of the topic.

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